Ameritech Illinois

Capital Structure

Staff Proposal
December 31, 1999

Component	Balance	Percent of Total Capital
Short term Debt	$671,284,205	22.06%
Long-term Debt	$547,746,000	18.00%
Total Debt	$1,219,030,205	40.06%
Common Equity	$1,824,500,000	59.94%
Total Capitalization	$3,043,530,205	100.00%

Docket Nos. 98-0252/0335 (Consol.)
Staff Exhibit 11.0
Schedule 11.02

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Average Balance of Short-Term Debt

Month	End of Month Balance of Short-Term Debt	Monthly Average
June-99	$398,000	
July-99	$793,342,000	$396,870,000
August-99	$766,412,000	$779,877,000
September-99	$1,070,252,000	$918,332,000
October-99	$862,424,000	$966,338,000
November-99	$772,636,000	$817,530,000
December-99	$735,506,000	$754,071,000
January-00	$522,255,106	$628,880,553
February-00	$496,998,573	$509,626,840
March-00	$448,983,697	$472,991,135
April-00	$666,303,530	$557,643,614
May-00	$600,187,845	$633,245,688
June-00	$639,821,414	$620,004,630
Average		**$671,284,205**

Sources: Company Reponses to Staff Data Requests SDR-071 and JF-4.01.

Docket Nos. 98-0252/0335 (Consol.)
Staff Exhibit 11.0
Schedule 11.03

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Embedded Cost of Long-Term Debt
As of December 31, 1999 ($000)

Issue	Date Issued	Maturity Date	Interest Rate	Principal Amount	Unamortized Discount	Unamortized Debt Expense	Carrying Value	Annual Coupon Interest	Annual Amortization	Annual Debt Expense
Series H First Mortgage Bonds	07/01/63	07/01/03	4.375%	$50,000	($17)	$19	$50,002	$2,188	$10	$2,198
Debentures	03/15/93	03/15/24	7.250%	$200,000	($1,923)	$527	$198,604	$14,500	$102	$14,602
Debentures	07/01/93	07/01/23	7.125%	$100,000	($1,278)	$279	$99,001	$7,125	$66	$7,191
Notes	02/01/94	02/01/04	5.800%	$100,000	($308)	$18	$99,710	$5,800	$79	$5,879
Debentures	02/01/94	02/01/25	6.625%	$100,000	($2,536)	$35	$97,499	$6,625	$103	$6,728
Capital Leases				$2,930			$2,930	$245	$0	$245
Total				$552,930	($6,062)	$878	**$547,746**	$36,483	$360	**$36,843**
Embedded Cost of Long-term Debt										**6.73%**

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The Discounted Cash Flow Model

Discounted cash flow (DCF) theory posits the value of an asset equals the sum of the future cash flows it generates, discounted by the investor-required rate of return. Specifically, the market value of common stock equals the present value of the expected stream of future dividends.

In its general form, the DCF model for a stock paying dividends quarterly can be mathematically stated as follows:

$$P = \frac{D_{1,1}}{(1+k)^{x}} + \frac{D_{1,2}}{(1+k)^{x+0.25}} + \frac{D_{1,3}}{(1+k)^{x+0.50}} + \frac{D_{1,4}}{(1+k)^{x+0.75}} + \frac{D_{2,1}}{(1+k)^{x+1.00}} + \frac{D_{2,2}}{(1+k)^{x+1.25}} + \frac{D_{2,3}}{(1+k)^{x+1.50}} + \frac{D_{2,4}}{(1+k)^{x+1.75}} + \cdots + \frac{D_{t,q}}{(1+k)^{x+m}} + \cdots \quad (1)$$

where P = the current market value;

$D_{t,q}$ = the expected dividend at the end of quarter q in year t, where q = 1 to 4 and t = 1 to ∞;

k = the cost of common equity;

x = the elapsed time between the stock observation and first dividend payment dates, in years; and

m = t - 1 + 0.25 (q - 1).

If dividends grow annually at a constant rate then,

$$D_{t+1} = D_{t+1,q}(1+g) \quad (2)$$

where: g = the expected growth rate in dividends.

Substituting Equation (2) into Equation (1) produces:

$$P = \frac{D_{0,1}(1+g)}{(1+k)^{x}} + \frac{D_{0,2}(1+g)}{(1+k)^{x+0.25}} + \frac{D_{0,3}(1+g)}{(1+k)^{x+0.50}} + \frac{D_{0,4}(1+g)}{(1+k)^{x+0.75}} + \frac{D_{0,1}(1+g)^{2}}{(1+k)^{x+1.00}} + \frac{D_{0,2}(1+g)^{2}}{(1+k)^{x+1.25}} + \frac{D_{0,2}(1+g)^{2}}{(1+k)^{x+1.50}} + \frac{D_{0,4}(1+g)^{2}}{(1+k)^{x+1.75}} + \cdots + \frac{D_{0,4}(1+g)^{t}}{(1+k)^{x+t+0.25}} + \cdots \quad (3)$$

Equation (3) has an infinite number of terms (t = 1 to ∞). To obtain a finite number of terms, first multiply each side of the equation by the quantity (1+k)/(1+g):

$$\frac{P(1+k)}{(1+g)} + \frac{D_{0,1}(1+g)(1+k)}{(1+g)(1+k)^{x}} + \frac{D_{0,2}(1+g)(1+k)}{(1+g)(1+k)^{x+0.25}} + \frac{D_{0,3}(1+g)(1+k)}{(1+g)(1+k)^{x+0.50}} + \frac{D_{0,4}(1+g)(1+k)}{(1+g)(1+k)^{x+0.75}} + \frac{D_{0,1}(1+g)^{2}(1+k)}{(1+g)(1+k)^{x+1.00}} + \frac{D_{0,2}(1+g)^{2}(1+k)}{(1+g)(1+k)^{x+1.25}} + \frac{D_{0,2}(1+g)^{2}(1+k)}{(1+g)(1+k)^{x+1.50}} + \frac{D_{0,4}(1+g)^{2}(1+k)}{(1+g)(1+k)^{x+1.75}} + \cdots + \frac{D_{0,4}(1+g)^{t}(1+k)}{(1+g)(1+k)^{x+t+0.25}} + \cdots \quad (4)$$

Eliminating redundant terms produces:

$$\frac{P(1+k)}{(1+g)} + D_{0,1}(1+k)^{1+x} + D_{0,2}(1+k)^{1+(x+0.25)} + D_{0,3}(1+k)^{1+(x+0.50)} + D_{0,4}(1+k)^{1+(x+0.75)} + \frac{D_{0,1}(1+g)}{(1+k)^{x}} + \frac{D_{0,2}(1+g)}{(1+k)^{x+0.25}} + \frac{D_{0,3}(1+g)}{(1+k)^{x+0.50}} + \frac{D_{0,4}(1+g)}{(1+k)^{x+0.75}} + \cdots + \frac{D_{0,4}(1+g)^{t+1}}{(1+k)^{x+t+1.25}} + \cdots \quad (5)$$

Next, subtract Equation (3) from Equation (5):

$$\frac{P(1+k)}{(1+g)} + P + D_{0,1}(1+k)^{1+x} + D_{0,2}(1+k)^{1+(x+0.25)} + D_{0,3}(1+k)^{1+(x+0.50)} + D_{0,4}(1+k)^{1+(x+0.75)} + \frac{D_{0,1}(1+g)^{t}}{(1+k)^{x+t+1.00}} + \frac{D_{0,2}(1+g)^{t}}{(1+k)^{x+t+0.75}} + \frac{D_{0,3}(1+g)^{t}}{(1+k)^{x+t+050}} + \frac{D_{0,4}(1+g)^{t}}{(1+k)^{x+t+0.25}}. \quad (6)$$

For $k > g$, as $t \to \infty$, $\frac{D_{0,1}(1+g)^t}{(1+k)^{x+t+100}}$, $\frac{D_{0,2}(1+g)^t}{(1+k)^{x+t+0.75}}$, $\frac{D_{0,3}(1+g)^t}{(1+k)^{x+t+0.50}}$, and $\frac{D_{0,4}(1+g)^t}{(1+k)^{x+t+0.25}} \to 0$.

Therefore,

$$\frac{P(1+k)}{(1+g)} = P = D_{0,1}(1+k)^{1+x} + D_{0,2}(1+k)^{1+(x+0.25)} + D_{0,3}(1+k)^{1+(x+0.50)} + D_{0,4}(1+k)^{1+(x+0.75)} + \sum_{q=1}^{4} D_{0,1}(1+k)^{1+[x+0.25(q+1)]}. \quad (7)$$

The expression $(1+k)^{1-[x+0.25(q-1)]}$ is a future value interest factor. It measures the rate of return a dividend received in quarter q will earn if reinvested for $1-[x+0.25(q-1)]$ periods at the periodic opportunity cost k. A future value interest factor converts nominal to time values, thereby permitting the summation of cash flows paid at different times.

Multiplying each side by the expression $(1+g)$ produces:

$$P(1+k) = P(1+g) + \sum_{q=1}^{4} D_{0,q}(1+k)^{1+[x+0.25(q+1)]}. \quad (8)$$

Finally, solving for k results in:

$$k = \frac{\sum_{q=1}^{4} D_{0,q}(1+g)(1+k)^{1+[x+0.25(q+1)]}}{P} + g. \quad (9)$$

To measure the cost of common equity *k* when growth *g* does not become constant until period ? , first, restate Equation (1) as follows:

$$P = \frac{D_{1,1}}{(1+k)^{x}} + \frac{D_{1,2}}{(1+k)^{x+0.25}} + \frac{D_{1,3}}{(1+k)^{x+0.75}} + \ldots + \frac{D_{?,4}}{(1+k)^{x+?+0.25}} + \frac{P_{?,4}}{(1+k)^{x+?+0.25}} \quad (10)$$

where: $P_{?,4}$[1] ? the market value at the conclusion of the short-term growth stage;
? ? the total length of the short-term growth stage.

Next, multiply each side of the equation by the factor $(1+k)^{x+?-0.25}$:

$$P(1+k)^{x+?+0.25} = D_{1,1}(1+k)^{?+0.25} + D_{1,2}(1+k)^{?+0.50} + D_{1,3}(1+k)^{?+0.75} + \ldots + D_{?,4} + P_{?,4} \quad (11)$$

Finally, solve for *k*:

$$(1+k)^{x+?+0.25} = \frac{D_{1,1}(1+k)^{?+0.25} + D_{1,2}(1+k)^{?+0.50} + D_{1,3}(1+k)^{?+0.75} + \ldots + D_{?,4} + P_{?,4}}{P} \quad (12)$$

$$k = \left[\frac{D_{1,1}(1+k)^{?+0.25} + D_{1,2}(1+k)^{?+0.50} + D_{1,3}(1+k)^{?+0.75} + \ldots + D_{?,4} + P_{?,4}}{P}\right]^{\frac{1}{x+?+0.25}} - 1 \quad (13)$$

[1] $P_{?,4}$ is found by solving Equation (9) for the stock price:

$$P_{?,4} = \frac{\sum_{q=1}^{4} D_{?,q}(1+g_l)(1+k)^{1-[x+0.25(q-1)]}}{k - g_l}$$

where: $D_{?,q}$? the dividend paid in quarter q during the last year of the short-term growth stage; and
g_l ? the long-term growth rate.

Staff Exhibit 11.0
Schedule 11.04

Staff Exhibit 11.0
Schedule 11.05

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Growth Rate Estimates and Ranges

Company	Zacks Earnings	IBES Earnings	Average Growth Rate
Bell South Corporation	11.10%	10.94%	11.02%
CenturyTel Inc.	14.39%	15.10%	14.75%
SBC Communications	13.83%	13.00%	13.42%
Verizon Communications	11.87%	11.60%	11.74%
Hickory Tech Corporation	na	15.00%	15.00%

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Quarterly Dividends and Stock Prices as of September 6, 2000

Company	Current Dividend $D_{0,1}$	$D_{0,2}$	$D_{0,3}$	$D_{0,4}$	Next Dividend Payment Date	Stock Price
Bell South Corporation	$ 0.190	$ 0.190	$ 0.190	$ 0.190	11/1/2000	$ 37.9400
CenturyTel Inc.	0.048	0.048	0.048	0.048	12/15/2000	28.0600
SBC Communications	0.244	0.244	0.254	0.254	11/1/2000	42.9400
Verizon Communications	0.385	0.385	0.385	0.385	11/1/2000	42.8800
Hickory Tech Corporation	0.110	0.110	0.110	0.110	12/5/2000	19.9400

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Schedule 11.07

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Expected Quarterly Dividends

Company	$D_{1,1}$	$D_{1,2}$	$D_{1,3}$	$D_{1,4}$
Bell South Corporation	$ 0.211	$ 0.211	$ 0.211	$ 0.211
CenturyTel Inc.	0.055	0.055	0.055	0.055
SBC Communications	0.254	0.254	0.288	0.288
Verizon Communications	0.430	0.430	0.430	0.430
Hickory Tech Corporation	0.127	0.127	0.127	0.127

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Schedule 11.08

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DCF Cost of Common Equity Estimates
Constant Growth Scenario

Company	
Bell South Corporation	13.38%
CenturyTel Inc.	15.57%
SBC Communications	16.12%
Verizon Communications	16.04%
Hickory Tech Corporation	17.70%
Average	**15.76%**

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DCF Cost of Common Equity Estimates
Non-Constant Growth Scenario

Company	
Bell South Corporation	7.84%
CenturyTel Inc.	6.13%
SBC Communications	8.61%
Verizon Communications	10.25%
Hickory Tech Corporation	8.67%
Average	**8.30%**

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Schedule 11.10

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Risk Premium Analysis

Interest Rates as of September 6, 2000

U.S. Treasury Bills[1]		U.S. Treasury Bonds[2]	
Discount Rate	Effective Yield	Bond Equivalent Yield	Effective Yield
6.03%	6.35%	5.71%	5.79%

[1] [1]U.S. Treasury bill yields are quoted on a 360-day discount basis. The effective yield is determined as follows:

$$\text{Effective yield} = \left[1 + \frac{\text{discount rate} \times \frac{\text{days to maturity}}{360}}{1 - \text{discount rate} \times \frac{\text{days to maturity}}{360}}\right]^{\frac{365}{\text{days to maturity}}} - 1$$

Error! Main Document Only. where *days to maturity* equals ninety-one days.

[2]The bond equivalent yield on U.S. Treasury bonds represents a nominal rather than an effective yield. The effective yield is calculated as follows:

Effective yield = [1 + (bond equivalent yield ÷ 2)]^2 − 1.

Staff Exhibit 11.0
Schedule 11.10

Risk Premium Cost of Equity Estimates

Risk-Free Rate Proxy	Risk-Free Rate		Beta		Risk Premium		Cost of Common Equity
U.S. Treasury Bills	6.35%	+	0.85	?	(16.18% ? 6.35%)	=	14.71%
U.S. Treasury Bonds	5.79%	+	0.85	?	(16.18% ? 5.79%)	=	14.62%

Staff Exhibit 11.0
Schedule 11.11

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Overall Cost of Capital

December 31, 1999

Component	Percent of Total Capital	Cost	Weighted Cost
Short term Debt	22.06%	6.61%	1.46%
Long-term Debt	18.00%	6.73%	1.21%
Total Debt	40.06%		2.67%
Common Equity	59.94%	11.80 - 14.40%	7.07 - 8.63%
	100.00%		
Weighted Average Cost of Capital			**9.74 - 11.30%**

Overall Cost of Capital Midpoint Estimate: **10.52%**
(Based on cost of equity midpoint estimate of 13.10%)